

ECONOMIC OUTLOOK AND REVENUE ESTIMATES FOR MICHIGAN

**FY 2004-05
AND
FY 2005-06**



HOUSE
FISCAL
AGENCY
Mitchell E. Bean, Director

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FOREWORD

The House Fiscal Agency (HFA) is pleased to present this report to members of the Michigan House of Representatives. The purpose of the report is to inform members of the revised General Fund/General Purpose and School Aid Fund revenue estimates for fiscal year (FY) 2004-05 and FY 2005-06. The estimates reported herein will be presented to the Consensus Revenue Estimating Conference on August 17, 2005, and will be used to facilitate the consensus estimating process.

This report includes the House Fiscal Agency's analysis of important factors that will affect state and national economies through the year 2006, estimates of the Countercyclical Budget Stabilization Fund, state compliance with the Constitutional State Revenue Limit, and year-end balance estimates for General Fund/General Purpose (GF/GP) and the School Aid Fund (SAF).

Rebecca Ross, Senior Economist, and Jim Stansell, Economist, are the authors of this report. Jeanne Dee, Administrative Assistant, prepared the report for publication.

EXECUTIVE SUMMARY

This report provides information that will be discussed at the August 17, 2005, Consensus Revenue Estimating Conference.

Tables 1 and 2: HFA Recommended Revisions From May 2005 Consensus

Provides HFA recommendations for revised estimates for FY 2004-05 and FY 2005-06 GF/GP and SAF revenue.

- Total *actual/net* GF/GP and SAF revenue shows a recommended increase of \$59.8 million (to \$18,824.9) for FY 2004-05.
- Total *actual/net* GF/GP and SAF revenue shows a recommended increase of \$83.6 million (to \$19,462.7) for FY 2005-06.

Table 3: Economic Forecast Variables

Provides estimates of various state and national economic variables.

- Real gross domestic product (GDP) is forecast to grow 3.6% in calendar year (CY) 2005 and 3.1% in CY 2006.
- Michigan personal income is forecast to grow 3.1% in CY 2005 and 6.1% in CY 2006.

Table 4: GF/GP Revenue Estimates

Provides detail for HFA August 2005 GF/GP revenue estimates. Total GF/GP *actual/net* revenue shows an increase of \$251.4 million from FY 2004-05 to FY 2005-06 (from \$8,002.1 million to \$8,253.5 million).

Table 5: School Aid Fund Revenue Estimates

Provides detail for HFA August 2005 SAF revenue estimates. Total SAF *actual/net* revenue shows an increase of \$386.3 million from FY 2004-05 to FY 2005-06 (from \$10,822.8 million to \$11,209.2 million).

Table 6: Year-End Balances

Provides actual and HFA estimates of year-end balances for GF/GP, SAF, and the Budget Stabilization Fund (BSF). The House Fiscal Agency estimates no balance in the GF/GP or SAF for FY 2004-05. Under current law, the BSF is estimated to have an \$86.1 million balance for FY 2004-05.

BSF Year-End Balance

No pay-in or withdrawal is estimated for FY 2004-05.

Compliance With the State Revenue Limit

State revenue is estimated to be substantially below the revenue limit for FY 2004-05 (\$5.42 billion) and FY 2005-06 (\$5.46 billion).

FORECAST REVISIONS AND ECONOMICS

This section provides HFA recommended revisions to the May 2005 consensus forecast, and state and national economic data for calendar years 2003 through 2006 (data for calendar years 2005 and 2006 are HFA estimates).

- Tables 1 and 2 report HFA recommended GF/GP and SAF revisions for FY 2004-05 and FY 2005-06.
- Table 3 shows the economic data used by the HFA to produce its updated revenue forecasts.

Table 1
FISCAL YEAR 2004-05 HFA RECOMMENDED REVISIONS
(Millions of Dollars)

	<u>May 2005 Consensus</u>	<u>HFA August 2005 Recommendation</u>	<u>Recommended Revision</u>
<i>BASELINE</i>			
GF/GP	\$8,177.7	\$8,265.1	\$87.4
SAF	<u>10,850.7</u>	<u>10,827.1</u>	<u>(23.6)</u>
	\$19,028.4	\$19,092.2	\$63.8
<i>ACTUAL/NET</i>			
GF/GP	\$7,914.7	\$8,002.1	\$87.4
SAF	<u>10,850.5</u>	<u>10,822.8</u>	<u>(27.7)</u>
	\$18,765.1	\$18,824.9	\$59.8

NOTE: Numbers may not add due to rounding.

Table 2
FISCAL YEAR 2005-06 HFA RECOMMENDED REVISIONS
(Millions of Dollars)

	<u>May 2005 Consensus</u>	<u>HFA August 2005 Recommendation</u>	<u>Recommended Revision</u>
<i>BASELINE</i>			
GF/GP	\$8,368.3	\$8,486.7	\$118.4
SAF	<u>11,236.2</u>	<u>11,201.6</u>	<u>(34.6)</u>
	\$19,604.5	\$19,688.3	\$83.8
<i>ACTUAL/NET</i>			
GF/GP	\$8,135.1	\$8,253.5	\$118.4
SAF	<u>11,244.1</u>	<u>11,209.2</u>	<u>(34.9)</u>
	\$19,379.2	\$19,462.7	\$83.6

NOTE: Numbers may not add due to rounding.

Table 3
ECONOMIC FORECAST VARIABLES

	<u>Calendar 2003</u>	<u>Calendar 2004</u>		<u>Calendar 2005</u>		<u>Calendar 2006</u>	
	<u>Actual</u>	<u>Actual</u>	<u>Change from Prior Year</u>	<u>Estimated</u>	<u>Change from Prior Year</u>	<u>Estimated</u>	<u>Change from Prior Year</u>
<u>United States</u>							
Real Gross Domestic Product <i>(Billions of 2000 dollars)</i>	\$10,320.6	\$10,755.7	4.2%	\$11,146.5	3.6%	\$11,487.7	3.1%
Implicit Price Deflator GDP <i>(2000 = 100)</i>	106.3	109.1	2.6%	112.0	2.7%	115.6	3.2%
Consumer Price Index <i>(1982-84 = 100)</i>	184.0	188.9	2.7%	194.7	3.1%	200.0	2.8%
Personal Consumption Deflator <i>(2000 = 100)</i>	105.5	108.2	2.6%	111.2	2.7%	114.0	2.6%
3-month Treasury Bills Interest Rate <i>(Percent)</i>	1.0%	1.4%		3.2%		4.0%	
Aaa Corporate Bonds Interest Rate <i>(Percent)</i>	5.7%	5.6%		5.4%		6.2%	
Unemployment Rate - Civilian <i>(Percent)</i>	6.0%	5.5%		5.1%		5.0%	
Light Vehicle Sales <i>(Millions of units)</i>	16.6	16.9	1.3%	17.0	0.7%	16.9	-0.6%
Passenger Car Sales <i>(Millions of units)</i>	7.6	7.5	-1.4%	7.6	1.1%	7.7	1.2%
Light Truck Sales <i>(Millions of units)</i>	9.0	9.4	3.7%	9.4	0.0%	9.2	-2.1%
Import Share of Light Vehicles <i>(Percent)</i>	19.9%	20.2%		20.1%		20.6%	
Personal Income <i>(Billions of current dollars)</i>	\$9,169.9	\$9,713.3	5.9%	\$10,324.9	6.3%	\$11,059.3	7.1%
Real Disposable Income <i>(Billions of 2000 dollars)</i>	\$7,741.8	\$8,004.1	3.4%	\$8,193.0	2.4%	\$8,552.1	4.4%
<u>Michigan</u>							
Wage and Salary Employment <i>(Thousands)</i>	4,409.3	4,393.9	-0.3%	4,382.4	-0.3%	4,412.0	0.7%
Unemployment Rate <i>(Percent)</i>	7.1%	7.1%		7.2%		7.3%	
Personal Income <i>(Millions of current dollars)</i>	\$314,345	\$323,142	2.8%	\$333,280	3.1%	\$353,510	6.1%
Real Personal Income <i>(Millions of 1982-84 dollars)</i>	\$172,197	\$174,226	1.2%	\$175,257	0.6%	\$181,587	3.6%
Real Disposable Income <i>(Millions of 1982-84 dollars)</i>	\$153,552	\$155,973	1.6%	\$155,678	-0.2%	\$160,787	3.3%
Wages and Salary Income <i>(Millions of current dollars)</i>	\$176,646	\$180,059	1.9%	\$182,402	1.3%	\$191,492	5.0%
Detroit Consumer Price Index <i>(1982-84 = 100)</i>	182.6	185.5	1.6%	190.2	2.5%	194.7	2.4%

REVENUE AND YEAR-END BALANCES

Revenue estimates are based on the economic performance of key components of national and state economies discussed in the preceding section. This section explains August 2005 House Fiscal Agency revenue estimates for GF/GP and School Aid Fund (SAF) revenue by major revenue sources. It provides revenue estimates, year-end balances for the major funds and the budget stabilization fund, and the state revenue limit calculation.

GF/GP Revenue by Source

Actual GF/GP revenue takes tax changes into account and is available for expenditure each year. *Final actual GF/GP revenue* was \$8,042.1 million in FY 2003-04; it is forecast to decrease by 0.5% or \$40.0 million to \$8,002.1 million in FY 2004-05. Actual GF/GP revenue is forecast to increase by 3.1% or \$251.4 million to \$8,253.5 million in FY 2005-06.

Table 4
GF/GP REVENUE ESTIMATES
(Millions of Dollars)

	Final			Fiscal Year 2005-06 over 2004-05	
	<u>FY 2003-04</u>	<u>FY 2004-05</u>	<u>FY 2005-06</u>	<u>% Change</u>	<u>\$ Change</u>
Personal Income Taxes	\$3,997.4	\$4,171.4	\$4,292.2	2.9%	\$120.9
Sales and Use Taxes	968.6	1,022.8	1,074.8	5.1%	52.0
SBT and Insurance Taxes	2,071.7	2,163.5	2,225.0	2.8%	61.5
Other Taxes	<u>629.7</u>	<u>637.1</u>	<u>635.4</u>	-0.3%	<u>(1.7)</u>
GF/GP Baseline Tax Revenue	\$7,667.4	\$7,994.8	\$8,227.4	2.9%	\$232.6
Non-Tax Revenue	<u>325.4</u>	<u>270.3</u>	<u>259.3</u>	-4.1%	<u>(11.0)</u>
Total GF/GP Baseline Revenue	\$7,992.8	\$8,265.1	\$8,486.7	2.7%	\$221.6
Adjustments to Baseline	<u>49.3</u>	<u>(263.0)</u>	<u>(233.2)</u>	11.3%	\$29.8
Actual GF/GP Revenue	\$8,042.1	\$8,002.1	\$8,253.5	3.1%	\$251.4

NOTE: Numbers may not add due to rounding.

SAF Revenue by Source

Actual SAF revenue takes tax changes into account. Final *actual SAF revenue* totaled \$10,615.6 million in FY 2003-04; revenue is forecast to increase \$207.3 million or 2.0% to \$10,822.8 million in FY 2004-05. Actual SAF revenue is forecast to increase \$386.3 million or 3.6% to \$11,209.2 million in FY 2005-06.

Table 5
SCHOOL AID FUND REVENUE ESTIMATES
(Millions of Dollars)

	<u>Final</u> <u>FY 2003-04</u>	<u>FY 2004-05</u>	<u>FY 2005-06</u>	<u>Fiscal Year 2005-06</u> <u>over 2004-05</u>	
				<u>% Change</u>	<u>\$ Change</u>
Sales and Use Tax	\$5,155.9	\$5,280.7	\$5,490.0	4.0%	209.3
Income Tax Earmark	1,895.7	1,998.0	2,068.4	3.5%	70.3
State Education Tax	1,750.7	1,853.6	1,950.0	5.2%	96.4
Lottery and Casinos	740.7	738.4	744.7	0.9%	6.3
Tobacco Taxes	481.2	464.6	456.7	-1.7%	(7.9)
Real Estate Transfer Tax	317.5	310.0	310.0	0.0%	0.0
Other Taxes	<u>191.9</u>	<u>181.8</u>	<u>181.8</u>	<u>0.0%</u>	<u>0.0</u>
Baseline SAF Revenue	\$10,533.6	\$10,827.1	\$11,201.6	3.5%	\$374.4
Adjustments to Baseline	<u>82.0</u>	<u>(4.3)</u>	<u>7.6</u>	<u>-276.7%</u>	<u>\$11.9</u>
Actual SAF Revenue	\$10,615.6	\$10,822.8	\$11,209.2	3.6%	\$386.3

NOTE: Numbers may not add due to rounding.

HFA Estimates of Year-End Balances

Table 6 reports House Fiscal Agency estimates of year-end balances for GF/GP, the SAF, and the BSF for FY 2004-05. Final FY 2002-03, and 2003-04 figures are also shown.

Table 6
YEAR-END BALANCE ESTIMATES
(Millions of Dollars)

	<u>Final</u> <u>FY 2002-03</u>	<u>Final</u> <u>FY 2003-04</u>	<u>Estimated</u> <u>FY 2004-05</u>
General Fund/General Purpose	\$174.0	\$0.0	\$0.0
School Aid Fund	\$113.7	\$74.1	\$0.0
Budget Stabilization Fund	\$0.0	\$81.3	\$86.1

BSF Year-End Balance

The Counter-Cyclical Budget and Economic Stabilization Fund (BSF), or the state's rainy day fund, is a reserve of cash to contribute to or withdraw from throughout the economic cycles. The BSF trigger calculation, which is based on Michigan personal income less transfer payments adjusted for inflation and actual or net GF/GP revenue, indicates no pay-in or withdrawal for FY 2004-05.

Compliance With the State Revenue Limit

Article IX, Section 26 of the *Michigan Constitution*, which was approved by the vote of the people in 1978, sets a limit on the amount of revenue collected by the state in any fiscal year. As provided for in the Constitution, the revenue limit is calculated as 9.49% of total state personal income (which is the broadest measure of state economic activity) in the previous full calendar year prior to the fiscal year in which the revenue is measured.

The revenue to be considered in the revenue limit includes not only state taxes, but also fees, licenses, and interest earned. Federal aid is not included in the revenue limit calculation.

Article IX, Section 26, *Constitution of the State of Michigan*, provides that:

. . . For any fiscal year in the event that Total State Revenues exceed the limit established in this section by 1% or more, the excess revenues shall be refunded pro rata based on the liability reported on the Michigan income tax and single business tax (or its successor tax or taxes) annual returns filed following the close of such fiscal year. If the excess is less than 1%, this excess may be transferred to the State Budget Stabilization Fund

Furthermore, the state is prohibited from spending any current-year revenue in excess of the limit established in Section 26 by Article IX, Section 28.

The final FY 2003-04 revenue limit calculation indicated that state revenue collections were \$4.18 billion below the revenue limit. For FY 2004-05 through FY 2005-06, state revenue is estimated to be substantially below the revenue limit, by \$5.42 billion and \$5.46 billion, respectively.

RISKS AND UNCERTAINTIES

An economic forecast is based on the best information available at the time the forecast is made. Because information and foresight are not perfect, risks and uncertainties are inherent in any forecast. The key risks in this forecast stem predominantly from uncertainties surrounding the price of oil, the housing market, and the intense competition in the motor vehicle industry.

Oil Prices

The average West Texas Intermediate (WTI) crude oil price was \$53 per barrel in the second quarter of 2005—approximately \$15 per barrel higher than in the year-ago quarter. Oil prices are forecast to remain elevated throughout 2005 and 2006 and are expected to average \$55 per barrel in both CY 2005 and CY 2006. These prices are significantly higher than the previously-estimated long-term trend price of oil.

Strong global supply and demand constraints have contributed to the recent high oil prices. Geopolitical uncertainties in Iraq, Nigeria, and Venezuela are also expected to contribute to the risks.

Oil prices affect the economy primarily through allocation of disposable income—because more income is used for oil based goods, less is used for all other items. Oil prices could fall below the estimated level, causing economic growth to be stronger than anticipated. On the other hand, oil prices may be higher than estimated, resulting in economic growth below the forecasted level.

Housing Market

National housing activity has remained exceptionally strong over the last several months. In CY 2004, new and existing home sales increased approximately 10% while median prices increased over 9%. Despite increases in short-term interest rates, housing prices have accelerated over the last two years. In addition, over the last few years, consumer spending has been aided by refinancing activity on homes that have appreciated in value.

The housing market is expected to slow as interest rates continue to move higher. As housing market cools, both in home sales and refinancing activity, consumer spending is expected to slow. Consumption is forecast to grow 3.7% in CY 2005 and 3.2% in CY 2006.

Michigan's Motor Vehicle Industry

The level and composition of light motor vehicle sales is a key component of Michigan's economy. Light vehicle sales were 16.9 million units in CY 2004 and are forecast to be 17.0 million in CY 2005 before declining slightly to 16.9 million in CY 2006. The import share of light vehicles was 20.2% in CY 2004 and is forecast to be 20.1% in CY 2005 and 20.6% in CY 2006.

The 2004 market share of the big three auto manufacturers declined to an all-time low of 58.7% in CY 2004. In response to significant incentives offered by these manufacturers, July light vehicle sales increased (relative to a year ago) 15% for General Motors, 30% for Ford, and 27%

for DiamlerChrysler. The big three have also reduced prices on 2006 models to stem their market share decline.

Imports and vehicles with a foreign nameplate that are made in the U.S. (transplants) have steadily gained in market share over the past several years. The extent to which the domestic nameplates can recoup market share will have a direct impact on Michigan's economy.

Michigan transportation employment is forecast to decline 5.6% in CY 2005 and 3.6% in CY 2006. If the Michigan-produced market share of motor vehicles is less than anticipated, Michigan's economy and revenue growth will be lower than estimated.



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House Fiscal Agency
P.O. Box 30014
Lansing, MI 48909-7514
(517) 373-8080
FAX (517) 373-5874
www.house.mi.gov/hfa